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January 17, 1996

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Ex Parte

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, D.C. 20554

Re: In the Matter of 1993 Annual Access Tariff Filings, CC Docket 93-193

Dear Mr. Caton:

Please enter the attached material into the record in the item captioned above.

Sincerely,

Ken. Rust

Attachment

cc: G. Matise (letter only)
A. Stevens

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List ABCDE

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NYNEX

January 17, 1996

Geraldine Matise
Chief, Tariff Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: In the Matter of 1993 Annual Access Tariff Filings, CC Docket 93-193.

Dear Ms. Matisse:

In this investigation, the Commission is considering, *inter alia*, whether the NYNEX Telephone Companies properly applied the "add-back" principle to their lower formula adjustment ("LFA") revenues for during the 1992 and 1993 reporting periods. In their petitions for investigation of NYNEX's 1993 and 1994 tariffs and in their comments on NYNEX's Direct Case in this investigation, AT&T and MCI argued that NYNEX should not have applied add-back to LFA amounts. They argued that the Commission's price cap rules, prior to the adoption of the add-back rule in Docket 93-179, did not incorporate the add-back principle, at least with regard to the LFA.[1]

AT&T and MCI have now reversed their position. As is shown in the attached brief, which NYNEX submits for the record, AT&T and MCI agree with NYNEX that the add-back rule "has been implicit in the sharing rules from the beginning," and they noted, with approval, that NYNEX has applied the add-back principle to the LFA, which "mirrors" the sharing adjustment.[2]

Thus, the primary complainants against NYNEX's application of add-back in this investigation now agree with NYNEX that add-back was required under the Commission's original price cap rules, and that the Add-Back Rulemaking[3] merely made this

[1] *See* AT&T Opposition to Direct Cases, CC Docket No. 93-193, filed August 24, 1993, at pp. 21-23; MCI Opposition to Direct Cases, CC Docket No. 93-193, filed August 24, 1993, at p. 24.

[2] *See* Attachment at pp. 2, 4 n.3, 5 n.5, 6, 7, 8.

[3] Rate of Return Sharing and Lower Formula Adjustment, Report and Order, 10 FCC Rcd 5656, 5657 (1995).

requirement explicit. The Commission should take this into account in reaching its decision in this proceeding.

Sincerely,

Joseph Di Bella

Attachment

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IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 95-1217 (and consolidated cases)

BELL ATLANTIC TELEPHONE COMPANIES, et al.,

<u>Petitioners</u>,

v.

FEDERAL COMMUNICATIONS COMMISSION
and UNITED STATES OF AMERICA,

<u>Respondents</u>.

On Petitions for Review of Orders
of the Federal Communications Commission

CERTIFICATE AS TO PARTIES, RULINGS
AND RELATED CASES

The undersigned, counsel of record for AT&T Corp., certifies the following, pursuant to Federal Rule of Appellate Procedure 26.1 and D.C. Cir. Rule 28(a)(1):

A. <u>Parties and Amici</u>.

All parties, intervenors, and <u>amici</u> appearing below and in this Court are listed in Petitioners' brief and the FCC's brief.

Intervenor AT&T Corp. ("AT&T") is an interexchange telecommunications carrier providing both interstate and intrastate service. AT&T does not have any parent company. AT&T Capital Corporation, AT&T Credit Holdings,, Inc., AT&T Global Solutions Company (formerly NCR Corporation), LIN Broadcasting Corporation, and LIN Television Corporation are subsidiaries of AT&T having outstanding debt in the hands of the public.

Intervenor MCI Telecommunications Corporation ("MCIT") is a telecommunications common carrier and is a wholly-owned subsidiary MCI Communications Corporation ("MCIC"). MCIC is a publicly held corporation engaged in a wide variety of telecommunications businesses, including but not limited to national and international voice and data telecommunications services and information services. MCIT has no publicly held debt securities or any subsidiaries of affiliates with publicly held debt or equity securities, except that MCIC holds an equity interest in General Communications, Inc., a publicly held corporation, and MCIT holds an equity interest in IFP Holdings, Inc., the parent of In-Flight Phone Corporation, which has publicly traded debt securities.

Intervenor Ad Hoc Telecommunications Users Committee is an unincorporated entity consisting of sixteen companies, all of which are major purchasers and consumers of telecommunications services.

B. Ruling Under Review.

The ruling under review is identified in the Petitioners' brief and the FCC's brief.

C. Related Cases.

This cases has not previously been before this Court or any other court. There are no related cases pending in this Court, other than those consolidated in this proceeding.

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Counsel of Record for
Intervenor AT&T Corp.

Dated: October 27, 1995

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

GLOSSARY

LEC	Local Exchange Carrier
PCI	Price Cap Index

ORAL ARGUMENT SCHEDULED FOR DECEMBER 19, 1995

IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 95-1217 (and consolidated cases)

BELL ATLANTIC TELEPHONE COMPANIES, et al.,

Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION
and UNITED STATES OF AMERICA,

Respondents.

JOINT BRIEF OF INTERVENORS SUPPORTING THE ADD-BACK ORDER

Intervenors Ad Hoc Telecommunications Users Committee, AT&T Corp., and MCI Telecommunications Corporation ("Intervenors") respectfully submit this brief in support of the Federal Communications Commission ("FCC").

RELEVANT STATUTES AND REGULATIONS

All applicable statutes are contained in the briefs of the petitioners and the FCC.

ISSUES PRESENTED

1. Whether the FCC acted arbitrarily or capriciously in clarifying that its scheme of price cap regulation requires application of an "add-back rule" in order to avoid double counting of prior "sharing" adjustments under the Commission's system of price cap regulation.

2. Whether the Commission violated the Communications Act by requiring LECs to calculate their prospective sharing adjustments by applying the add-back rule.

3. Whether the Commission violated the rule against retroactive rulemaking by requiring LECs to apply the add-back rule to rates filed and charged after the effective date of the order.

INTRODUCTION AND STATEMENT OF THE CASE

Petitioners Ameritech Operating Companies and Bell Atlantic Telephone Companies ("Petitioners") seek review of an order of the Federal Communications Commission ("FCC") that clarifies one aspect of the FCC's system of incentive regulation for local exchange carriers ("LECs"). Price Cap Regulation of Local Exchange Carriers: Rate-of-Return Sharing and Lower Adjustment Formula, Report and Order, 10 FCC Rcd 5656 (1995) ("Add-Back Order" or "Order"). Specifically, in the Add-Back Order, the FCC made clear what had been implicit in this system all along: under the price cap system, a LEC must determine its "sharing" obligations for the current year based on its *pre-sharing* earnings from the previous year.

Petitioners' principal argument is that application of the Add-Back Order results in "double counting" of the LECs' sharing obligations. Yet, ironically, the very example Petitioners use to make this point rests upon improper double counting. When that error is removed, Petitioners' own example shows that failure to apply the add-back principle would effectively reduce the LECs' sharing obligations to something significantly below the 50 percent level specified in the Commission's regulations. Petitioners' other attacks on the Add-Back Order -- i.e., their "improper refund" and "retroactivity" arguments -- ignore the fact that the Commission has elected to apply the Add-Back Order prospectively only, thereby allowing Petitioners and the other LECs to keep the substantial windfalls they have already achieved through their creative interpretation of the Commission's original price cap regulations.

To place Petitioners' arguments in proper perspective, it is important to understand (1) the Commission's price cap system, including the sharing rules, and (2) the specific controversy that led to the order under review.

1. The Price Cap System and Sharing. Prior to 1990, the FCC used a traditional rate of return system to regulate the LECs' access charges. In 1990, however, the FCC adopted a new system of "price caps" to regulate the access charges of the largest LECs, including Petitioners.[1] Under price cap regulation, the interstate services provided by a LEC are grouped into categories called baskets. For each basket of services, the FCC established a maximum price, called the price cap index ("PCI"). As long as a LEC's tariffed rates remain below the PCI, those rates go into effect after a substantially "streamlined" review by the FCC.

Price cap regulation is intended to provide better incentives for the LECs than rate-of-return regulation: If a LEC is able to reduce costs or otherwise become more efficient, it is permitted to keep greater profits than it could have under rate of return regulation. See generally National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

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[1] Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786 (1990) ("LEC Price Cap Order"), recon., 6 FCC Rcd 2637 (1991) ("Reconsideration Order"), aff'd sub. nom National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

However, the FCC intended that consumers fare at least as well under price cap regulation as they had under rate of return regulation. Accordingly, the FCC sought to ensure that the efficiency gains that LECs would likely have achieved under rate of return regulation would be passed on to consumers through lower prices. Reconsideration Order, ¶ 3. The FCC's rules therefore require the LECs to lower their price cap indices each year by a certain percentage, known as the "productivity offset."[2] The productivity offset is an estimate of the LECs' annual increases in efficiency (based on historical, pre-price cap measures of LEC productivity). Under the original LEC Price Cap Order, the LECs were allowed to make an annual election of either 3.3 percent or 4.3 percent as a productivity offset. LEC Price Cap Order, ¶¶ 6-8, 75-102.

However, the FCC was concerned that these offsets might not accurately reflect the LECs' productivity growth. Id., ¶ 120. If the productivity offset is too low, for example, the annual reduction in the price caps will not keep pace with the LECs' productivity gains, and therefore consumers will not fully share in the benefits of incentive regulation, and may be made worse off than under traditional rate of return regulation.

In order to reduce this risk, the FCC adopted a "backstop program" called the sharing adjustment, the general validity of which is not disputed here. Id., ¶ 120. Sharing entails a one-time adjustment to a LEC's PCI when its rate of return for the previous year has been abnormally high.[3] The FCC reasoned that, in a year in which a LEC's earnings are particularly high, the productivity

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[2] The LECs' price caps would also be adjusted to account for inflation and for certain "exogenous" costs incurred by the LECs due primarily to regulation. LEC Price Cap Order, ¶ 5.

[3] In addition to the sharing adjustment, the FCC adopted a mechanism known as the "low-end" adjustment. This mechanism mirrors the sharing adjustment: Where a LEC's earnings are particularly low, the productivity offset has likely overstated the LEC's actual efficiency gains, and the LEC is therefore permitted to correct for that overstatement by increasing the following year's price cap index.

offset chosen by the LEC will probably have understated that LEC's actual gains in efficiency. Reconsideration Order, ¶ 102. The price cap system does not require a refund of such overearnings. However, a correction in the PCI for future rates is necessary in order to allow consumers to "share" in this additional, unanticipated productivity gain in the succeeding year. The FCC uses a percentage (usually 50 percent) of the LEC's earnings over a certain threshold as a proxy for determining this additional productivity gain, and requires that the LEC's PCI (though not necessarily its rates) be reduced by this amount during the following year.[4]

2. The Add-Back Controversy. How to account for such adjustments in subsequent years is the issue at the heart of the add-back controversy. That controversy arose in 1993, the third year of price cap regulation. Some LECs had achieved high earnings in 1991, which resulted in sharing obligations for 1992. These LECs then calculated their sharing obligations for 1993 based on post-sharing 1992 earnings, rather than pre-sharing earnings.[5] The Common Carrier Bureau immediately initiated a still-pending tariff investigation to examine the legality of this practice. At about the same time, the FCC initiated a rulemaking proceeding, which resulted in the Add-Back Order under review here.

In the Order, the FCC explained that a sharing adjustment made in Year 2 to recognize productivity gains achieved in Year 1 had be to "added back" to Year 2 revenues in order to

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[4] For example, under the original LEC Price Cap Order, if a LEC chose the 3.3 percent offset, it was required to "share" 50 percent of any returns above 12.25 percent, and 100 percent of any returns above 16.25 percent. Thus, if a LEC chose the 3.3 percent offset and achieved a 13.25 percent return in a given year, it would be allowed to keep the entire profit from that year, but it would have to make a one-time reduction in its price cap index the following year in order to recognize the fact that its productivity had increased faster than the FCC had predicted. LEC Price Cap Order, ¶¶ 7-8. For LECs that chose the 4.3 percent productivity offset, 50 percent sharing began at 13.25 percent and 100 percent sharing at 17.25 percent. Id.

[5] Notably, NYNEX, which had low earnings during this period and which took advantage of the low-end adjustment, did apply the add-back principle.

calculate Year 2 productivity gains (and thus the Year 3 sharing obligation). Otherwise, the LECs could count the same sharing adjustment against revenue in two separate years: the year in which the over-earnings were achieved and the subsequent year, when the corresponding adjustment to rates was made. See Add-Back Order, ¶ 23 ("ignoring the effects of a sharing adjustment will make a LEC's earnings, and therefore its productivity, appear to be lower than it actually is during the year in which the sharing amount is flowed through to ratepayers"). As the FCC explained, such double counting would result in ripple effects from year to year, and would allow the LECs effectively to reduce their total sharing obligations to a percentage below that required by the FCC's price cap rules.

For these reasons, the FCC made clear that the add-back rule had been implicit (as a matter of simple mathematics) in the sharing rules from the beginning. As the FCC stated, an "add-back requirement is not only fully consistent with, but also an essential element of, the system of price cap regulation." Id., ¶ 32. Nevertheless, the Order required the LECs to apply the add-back principle only to their calculation of sharing adjustments in future tariffs. These petitions for review followed.

SUMMARY OF ARGUMENT

The FCC acted well within its discretion in concluding that the add-back rule is an integral and necessary part of the FCC's scheme of price cap regulation. Without the add-back rule, the LECs would be permitted to count a given sharing adjustment against revenue in two different years, which would allow the LECs to reduce their effective sharing rates to a percentage below that required by the FCC's rules. Therefore, the add-back principle is fully consistent with the FCC's rules, and its adoption was not arbitrary and capricious.

Similarly, the add-back rule does not transform the sharing adjustments into improper refunds. As Petitioners concede, sharing adjustments are purely prospective. The add-back rule, moreover, does not change the basic nature of the sharing mechanism. The add-back rule merely ensures that the amount of the adjustment remains consistently equal to the percentage specified in the FCC's rules. Therefore, the Add-Back Order is also fully consistent with the Communications Act.

Finally, the Add-Back Order does not violate the rule against retroactive rulemaking. The sharing adjustments are purely prospective, and the FCC is plainly permitted to look to "antecedent facts" when making judgments about the magnitude of that adjustment. Similarly, the Add-Back Order does not upset any of Petitioners' legitimate reliance interests. Petitioners received all appropriate regulatory benefits from their previous productivity offset elections, and more. Petitioners could have had no legitimate expectation that any windfall resulting from the Commission's initial failure expressly to articulate the add-back principle would continue indefinitely. And even if the add-back principle had represented a change in the FCC's sharing policy (which it did not), Petitioners could have no legitimate expectation that the policy would be cast in stone.

ARGUMENT

The FCC's statutory authority to design systems of rate regulation is extremely broad, and the sorts of ratemaking judgments at issue in this case are at the core of the agency's expertise. See Aeronautical Radio, Inc. v. FCC, 642 F.2d 1221, 1228 (D.C. Cir. 1980), cert. denied, 451 U.S. 290 (1981); Permian Basin Area Rate Cases, 390 U.S. 747, 776 (1968). Such ratemaking judgments carry a "presumption of validity," and must be upheld if they are not "unjust and unreasonable in their consequences." FPC v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). Under those standards, the Add-Back Order was an entirely proper exercise of the FCC's discretion.

I. THE FCC DID NOT ACT ARBITRARILY IN CONCLUDING THAT THE ADD-BACK ADJUSTMENT IS NECESSARY TO THE PROPER FUNCTIONING OF THE SHARING REQUIREMENT.

Petitioners claim that the add-back rule is arbitrary and capricious because, in their view, under that rule a single sharing obligation can result in continuing sharing obligations in later years, *i.e.*, in double-counting. See Pet. Br. 15-21. But Petitioners have it exactly backward: As the Commission repeatedly found, the add-back principle is necessary to *avoid* double-counting, and has been implicit in the sharing rules from the beginning. See Resp. Br. 70.

This is apparent from a close inspection of Petitioners' own numerical example (at p. 19), which is at the heart of their entire argument. Petitioners' example appears to illustrate their point only because they have mixed cash accounting and accrual accounting, and in so doing have "double counted" the sharing obligations arising during the first year of the example.[6] See Res. Br. 57. In Year 1, the LEC in Petitioners' example exceeds the threshold by $1 million, which results in a $500,000 sharing obligation to be implemented in Year 2. Here, Petitioners' example applies the accrual method, and counts this $500,000 against the $1 million in earnings. In Year 2, however, Petitioners inexplicably switch to cash accounting. The $500,000 is paid out in Year 2 -- in the form of foregone earnings earmarked for that purpose -- but Petitioners also claim full credit for the $500,000 against Year 2 earnings, and argue that no new sharing adjustment is required. But Petitioners have counted the same $500,000 twice, against both Year 1 earnings and Year 2

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[6] Petitioner's numerical example is also somewhat contrived, in that it assumes that the LEC's pre-sharing earnings are constantly *declining* rather than increasing or, at least, remaining constant. Cf. Table 3.

earnings. The attached Tables 1 and 2 show the true state of affairs, assuming accrual accounting is consistently applied.

The flaw in Petitioners' argument is further demonstrated by assuming that the Commission had decided to implement the sharing requirement, not through changes in the PCI, but by requiring the LECs simply to write a check during Year 2 to its customers for the amount of the sharing obligation. During Year 2 in Petitioners' numerical example, the LEC would actually receive (through the rates it charges) the additional $500,000 above the sharing threshold, which it could then use to cover the $500,000 check for Year 1. In this example, it is easy to see that the $500,000 is not in any sense "phantom" earnings, as Petitioners erroneously claim (Pet. Br. 17-18). The LEC, moreover, would incur a new $250,000 sharing obligation from its Year 2 earnings.

Changing the mechanism by which the sharing requirement is implemented should not affect the LECs' total sharing obligation. Without the add-back principle, however, changing to a check-writing system would result in substantially higher sharing obligations. See also Table 3. Thus, the add-back rule is in fact necessary to the proper functioning of the sharing requirement.

Indeed, without that rule, the LECs would effectively be able to reduce their sharing adjustments to a percentage well below the percentage specified in the Commission's rules. To see why this is so, consider again Petitioners' numerical example. For Year 1 and Year 2 combined, the LEC in fact had $1.5 million in earnings above the sharing threshold, which (with the add-back rule) results in a total sharing adjustment of $750,000. However, without the add-back rule, the LEC's sharing adjustment would be only $500,000. In other words, the LEC's effective sharing rate would be reduced to 33 percent, while the Commission's rules actually require 50 percent sharing. See

Table 2.[7] Thus, as this example illustrates, as matter of simple mathematics the Commission's sharing rules have necessarily implied the add-back principle all along.

In short, the Commission's sharing rules make sense only if a LEC's sharing adjustment comes out of *pre-sharing* earnings, i.e., only if the add-back rule is applied. This is clearly seen not only in Tables 1 and 2, but also in Table 3, which shows (assuming constant rather than declining gross revenues) that the add-back principle is the only accurate measure of LEC earnings and the resulting sharing obligations.

The foregoing disposes of all of Petitioners' arbitrariness claims. First, because the add-back principle was implicit in the sharing mechanism all along, it is not inconsistent with the FCC's original sharing rules. See Pet. Br. 15-17 (arguing that the FCC was improperly "of two minds" in the rulemaking process). Second, as explained above, the add-back principle plainly does not result in improper reliance on "phantom" revenues. See id. at 17-18. Third, contrary to Petitioners' claims (id. at 19-21), the add-back principle is necessary to achieve the levels adjustments required by the Commission's rules, as explained in the FCC's Order. See Add-Back Order, ¶¶ 17-37, 42-45; see also Resp. Br. 55-58.

[7] Moreover, in Year 3 and Year 4, without the add-back principle, the LEC's effective sharing rate would remain consistently below 50 percent: The total, cumulative earnings above the threshold would be $1.87 million at the end of Year 4, but without the add-back rule the LEC has still shared only $625,000 rather than $935,000 (50 percent of the $1.87 million). The LEC would actually incur a sharing obligation in Year 3, because without the sharing adjustment from Year 2 (since there is no add-back), the LEC would in fact earn the additional $250,000 above the threshold. The LEC would thus have to share $125,000 in Year 4; hence the total sharing at the end of Year 4 would be $625,000.

II. BECAUSE THE ADD-BACK ADJUSTMENT IS A NECESSARY ELEMENT OF THE SHARING REQUIREMENT, THE FCC'S RULE DOES NOT VIOLATE THE COMMUNICATIONS ACT.

Petitioners also argue that the Add-Back Order violates the Communications Act because it "converts the sharing adjustment into an impermissible refund." Pet. Br. 14. This is false.

As Petitioners concede, the sharing adjustment is purely prospective. Id. at 12-13. It merely allows the LEC's customers to benefit from unanticipated productivity gains achieved in the prior year, through lower access charges. Moreover, the legality of the sharing mechanism itself has never been challenged, and Petitioners do not challenge it here. Thus, it is undisputed that the FCC has the authority under the Communications Act to require the LECs to "share" with their customers unanticipated productivity gains through a sharing device. See generally National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993) (affirming the original adoption of price cap regulation of the LECs, including aspects of sharing).

The add-back rule does not change the fundamental nature of the sharing mechanism. With or without that rule, the sharing mechanism is still a prospective adjustment designed to allow customers to share prospectively in the LEC's unanticipated productivity gains. The add-back principle merely makes the sharing mechanism work as the FCC originally intended it to work: As discussed above, only with the add-back rule will a LEC's effective sharing rate will consistently equal the sharing rate specified in the FCC's rules. The FCC's clarification of this point in the Add-Back Order did not suddenly transform the prospective cap adjustments into backward-looking refunds. See Resp. Br. 55.

Petitioners' entire argument is based on the assumption that the FCC sought to justify the add-back rule "on the ground that the sharing adjustment does operate as a refund" (Pet. Br. 14).

But this is obviously a misreading of the Add-Back Order. The FCC never said (or even implied) that the sharing mechanism *is* a refund, or that the add-back rule was necessary because the sharing mechanism is a refund. The FCC made clear that the mechanism by which refunds are determined was merely "relevant by *analogy*" to the sharing mechanism. Add-Back Order, ¶ 23 (emphasis added); see also id., ¶ 4 (describing the "analogous 'add-back' adjustment"); id., ¶ 17 (noting that under the price cap rules, the sharing obligation is a one-time adjustment, "in the same way that the refund mechanism operates"). The fact remains that, even with the add-back rule, the sharing mechanism still functions as a prospective adjustment, not as a refund. If, for example, a LEC had to charge well below the maximum rates allowed under its PCIs because of market or other conditions, the sharing adjustment might not have any impact, unlike a refund, which would have to be paid in any event.

At bottom, Petitioners appear to be arguing that, as long as the sharing mechanism results in an effective sharing rate below that specified in the FCC's rules, the sharing mechanism is a lawful, prospective adjustment, but if the rule is amended to ensure that the effective sharing rates are in fact what the FCC has prescribed, the sharing mechanism becomes an unlawful refund. Such illogical reasoning is no basis for concluding that the FCC violated the Communications Act.

III. THE ADD-BACK ADJUSTMENT DOES NOT CONSTITUTE IMPERMISSIBLE RETROACTIVE RULEMAKING.

Finally, Petitioners erroneously argue that the Add-Back Order has "two separate impermissibly retroactive effects." Pet. Br. 22. First, Petitioners claim that the add-back rule "increases a LEC's liability for past transactions" because it requires a LEC "to recalculate past earnings." Id. at 23-26. Second, the add-back rule is said to retroactively "alter[] the consequences" of the LEC's prior decision to choose the lower productivity offset. Id. at 26-29. Both arguments are meritless.

A. The Add-Back Order Does Not Retroactively Impose Additional Liability For Past Transactions.

The short answer to Petitioners' first argument is that the sharing rules do not, in fact, create any "liability for past transactions." As Petitioners concede elsewhere (Pet. Br. 12-13), the sharing adjustment applies only prospectively, and only to the LEC's price cap index, not to the rates themselves. Thus, unlike the hypothetical check-writing system discussed above, and unlike a tax obligation incurred in a prior year (see id. at 26), the Commission's sharing system does not impose any genuine "liability" on LECs at all.

Moreover, as the Supreme Court recently recognized, a rule "'is not made retroactive merely because it draws on antecedent facts for its operation.'" Landgraf v. USI Film Prods., 114 S.Ct. 1483, 1499 n.24 (1994) (quoting Cox v. Hart, 260 U.S. 427, 435 (1922)). That is all the add-back principle does: It draws upon the "antecedent facts" of a LEC's prior revenues and sharing obligations -- and what those revenues indicate about the LEC's productivity -- in establishing the LEC's sharing obligation for the next period.

Indeed, it was on this basis that this Court, in Association of Accredited Cosmetology Sch. v. Alexander, 979 F.2d 859, 863-66 (D.C. Cir. 1992) ("AACS"), previously found a rule similar to the one here to be purely prospective. In AACS, an association of trade schools challenged a rule promulgated by the Department of Education that terminated the member schools' eligibility to participate in federal loan programs if the schools' default rate on loans was excessive. The Department examined default rates before the effective date of the regulations to determine whether to terminate eligibility for the year 1992. Id. at 861-62. This Court rejected the Association's claim that this regulation acted retroactively, and the Court held that the rule does not "undo[] past eligibility," but merely "look[s] at schools' past default rates in determining future eligibility." Id. at 865.[8]

The Add-Back Order is equally prospective. The Order affects only future rates and future tariffs. It does not alter the legality of any past rates or tariffs, nor does it require the LECs to "refund" any past overearnings. See Resp. Br. 66-67. Therefore, the Add-Back Order cannot impermissibly retroactive.

B. The Add-Back Order Does Not Impermissibly Change The Consequences Of Past Productivity Offset Decisions.

Petitioners' argument that the Add-Back Order is unlawful because it "retroactively changes the consequences of a LEC's past choice of productivity offsets" (Pet. Br. 26) is equally meritless.[9] As explained above, the add-back principle was always implicit in the Commission's sharing mechanism. Hence there has been no genuine change in the law (even though the Commission has so far elected not to enforce the add-back principle with respect to some prior years).

But even if the Add-Back Order did represent a change in the law, that is no basis for overturning the Commission's decision. The Supreme Court has recently explained that a "statute

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[8] Petitioners, like the appellants in AACS, cite Bowen v. Georgetown Univ. Hosp., 488 U.S. 204 (1988), for support of their claim that the Add-Back Order operates retroactively. (Pet. Br. 25). The AACS court properly rejected this argument, and the same should be done here: "[i]n Bowen, it was undisputed that the HHS regulation . . . was retroactive." AACS, 979 F.2d at 865. Moreover, as Justice Scalia explained in his concurrence in Bowen, the rule against retroactivity applies only where a rule changes "the *past* legal consequences of past actions." Bowen, 488 U.S. at 219. The Add-Back Order does not change the legal effect of any past rates or tariffs, and therefore is not retroactive.

[9] Under the First Price Cap Order, each LEC was required to choose either the 3.3 percent or the 4.3 percent productivity offset each year. Petitioners and their affiant now claim that "had petitioner Ameritech known . . . that the Commission would later require add-back, it would have elected the 4.3 percent offset" in 1993 and 1994 instead of the 3.3 percent offset. Pet Br. 27.

does not operate 'retrospectively' merely because it . . . upsets expectations based in prior law." Landgraf, 114 S. Ct. at 1499 (citation omitted). In addition, this Court has stated that "[i]t is often the case that a business will undertake a certain course of conduct based on the current law, and will then find its expectations frustrated when the law changes. This has never been thought to constitute retroactive lawmaking, and indeed most economic regulation would be unworkable if all laws disrupting prior expectations were deemed suspect." Chemical Waste Management, Inc. v. EPA, 869 F.2d 1526, 1536 (D.C. Cir. 1989).

Under these principles, the Add-Back Order does not upset any legitimate reliance interests of the Petitioners for several reasons. First, Petitioner Ameritech could not have predicted with any accuracy in 1993 what its earnings would have been and what its resulting sharing obligations would have been in 1995. This is underscored by the fact that, according to Ameritech's own data, it would have been better off had it chosen the 4.3 percent offset in 1993 and 1994 regardless of the add-back rule. See Aff. of Thomas C. Etling, Ex. 1 (attached to Pet. Br. as Appendix C). Ameritech simply made a bet and lost.

Second, Ameritech had no justification for relying on the notion that the FCC would not formally adopt an add-back rule. In the first year in which the add-back controversy could have arisen (1993), the FCC immediately challenged the LECs' practice of ignoring the add-back principle in a tariff investigation and initiated the rulemaking proceeding under review here. Therefore, Petitioners' decision to ignore the add-back principle has been under a cloud from the beginning, and Petitioners have made all of their productivity offset elections with full notice of the risks involved. See Resp. Br. 69-71.

Finally, Petitioners have already received the full "benefit of its bargain" with the FCC under the prior rules. The Add-Back Order does not upset any of Petitioners' previous elections or the